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Why Advisors Still Use Mutual Funds

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ETFs are all the rage, but actively managed open-end funds still appeal to some wealth managers.

Reports of the death of mutual funds have been greatly exaggerated, even if the headlines suggest otherwise.

Sure, exchange-traded funds (ETFs) have been gathering assets at a furious pace in recent years. Meanwhile, the business of open-end mutual funds, which have been around for nearly a century, is relatively lethargic—or worse, for some firms. But as several financial advisors are quick to explain, there's still a strong case for using open-end products.

One advisor tells Horsesmouth that he uses only mutual funds for managing client accounts. Going all in with open-end products may be the exception these days, but several other advisors interviewed for this story report that they also use mutual funds to some degree. The reasons vary, but as we'll learn, there's a dedicated contingent that finds these products useful—if not superior—to ETFs.

Who needs ETFs?

One of the more enthusiastic proponents of mutual funds in the financial advisory community is David Demming, who heads up the eponymous Demming Financial Services in Aurora, Ohio.

"We use mutual funds exclusively," he says. Demming cites the "inefficiency of trading" with ETFs as one of several reasons for his preference. Although many ETFs appear to be inexpensively priced, he argues that the spreads that prevail in daily trading are troubling. By contrast, open-end funds trade at one price for everyone at the end of the day.

Helen Modly, a wealth advisor at Buckingham Strategic Wealth, agrees, pointing out that there's a non-zero possibility of extreme intraday trading swings in ETFs. That's an incentive to favor mutual funds whenever possible, she says. "The reason is guaranteed liquidity and accurate pricing" in open-end products.

As an example, consider how two virtually identical equal-weighted S&P 500 funds performed on August 24, 2015, a day of unusual intraday volatility. Although each fund closed down that day by roughly 4% versus the previous session, the ETF version—Invesco S&P 500 Equal Weight ETF (RSP)—traded in a wide band that approached a nearly 6% intraday price swing. For anyone unlucky enough to buy RSP at or near the intraday top (or sell near the intraday bottom), there was a hefty premium to pay above and beyond the loss via the end-of-day pricing in the mutual fund equivalent—Invesco Equally Weighted S&P 500 A (VADAX).

Such incidents, Modly concludes, “reinforced to me not to use an ETF when a mutual fund will do.”

Day traders will think differently, of course, since short-term volatility is the raw material for opportunity. But for investment strategies focusing on medium-to-long time horizons, there’s a certain logic in the idea of using mutual funds to sidestep the risk of extreme intraday volatility.

Comparing costs

Long-term investors often cite lower cost as a reason for using ETFs over mutual funds, and on this score the numbers offer support. According to ETFdb.com, the expense ratios for the 100 lowest-cost ETFs range from as little as 0.03% up to 0.08% [“100 Lowest Expense Ratio ETFs—Cheapest ETFs”]. Most ETFs charge more, although it’s easy to find a wide array of funds in various asset classes at 0.50% or lower.

Mutual funds, by contrast, tend to suffer by comparison, although the specifics can vary quite a bit, depending on the fund issuer and investment strategy. But since most mutual funds are actively managed, the related expenses tend to be higher versus ETFs, which are primarily managed as passive products—a focus that typically translates into lower operating costs.

A recent Morningstar study found that the asset-weighted average fee for actively managed funds at the end of 2017 was 0.73%—substantially above the 0.11% for passive funds [“U.S. Fund Fee Study,” April 26, 2018].

Accordingly, index mutual funds tend to be competitive with their ETF counterparts. Vanguard, for example, manages open-end index funds that match the expense ratios of their ETF equivalents. For instance, the open-end Vanguard Total Stock Market Index Fund Admiral Shares (VTSAX) and its counterpart, Vanguard Total Stock Market ETF (VTI), each charge a mere 0.04%.

Meanwhile, on August 1, Fidelity announced that it would begin offering the first index mutual funds with a zero-percent expense ratio for individuals. Presumably, other mutual fund companies will respond, providing what may turn out to be a new push in lowering fees generally.

Institutional shares

For advisors who use active mutual funds, one way to keep expenses low is to use institutional series products. That’s not always possible, but Demming prioritizes such funds to keep open-end products competitive with ETFs. He also looks for trading platforms for advisors with relatively low costs.

He adds that the details on how a mutual fund portfolio is managed can make a difference too. He points to Dimensional Fund Advisors (DFA), which uses several techniques to minimize expenses and reduce taxable consequences. For example, Demming says DFA excels in offsetting buy and sell trades within and across its funds in pursuit of lower taxable events. The company also prioritizes long-term holding strategies to minimize portfolio turnover, which keeps costs low and taxable events to a minimum.

ETF proponents are quick to remind that these products are more tax efficient versus mutual funds (assuming a taxable account) versus the same strategy in an open-end fund. True, but favoring mutual fund companies that go the extra mile in pursuing tax efficiency can narrow the differences substantially.

DFA's trading costs are a "fraction of what others charge," Demming reports. "DFA's investing models are probably more efficient. We have close to 50% of our money there."

Active management still attracts a crowd

For some advisors, the allure of mutual funds is primarily about tapping into active management. The academic and empirical research that backs indexing is extensive and widely regarded as persuasive. But some wealth managers aren't ready to embrace ETFs and index mutual funds for all clients at all times.

"We're using more ETFs over time," says Eric Kuby, chief investment officer of North Star Investment Management in Chicago, but the transition isn't absolute. "We believe that there are certain asset classes where active management matters."

For example, the firm uses Templeton Global Bond Fund (TPINX). Kuby explains that foreign fixed-income securities is "an asset class that's complicated and it's not easy to create an ETF that captures the skills of managers investing in global bonds." As a result, he believes this is a market corner where talented active management can add value.

Kuby's also a fan of using active management for micro-cap stocks. An ETF makes sense for large-cap firms, he concedes, but navigating through thousands of micro-caps, where research may be limited and perhaps non-existent, is another story. Active oversight in this corner "makes a lot of sense," he insists.

Owning a concentrated portfolio of, say, 50 micro-caps can complement a large-cap allocation, Kuby reasons. "The performances [for the two portfolios] is quite different."

Charles Adi selectively uses active mutual funds, focusing on international and bond markets. "I'm trying to find areas where we can outperform," says the financial planner at Blueprint 360 in Houston, Texas. He notes that roughly 25% of client portfolios are managed tactically, with an eye on "generating outperformance where possible."

A key issue, of course, is researching which funds are expected to deliver alpha (benchmark-beating performance). Adi employs several techniques, starting with reading Morningstar's reports on funds. He also looks for a number of key factors, including manager tenure (at least five years) and reviewing the portfolio's risk and return statistics to decide if the results can be attributed to the fund's strategy and management team.

He recognizes that active funds will usually have higher expenses versus an ETF equivalent. "But if the return justifies the cost, it makes sense to pay," Adi concludes.

Steve Tuttle, chief investment officer at Signet Financial Management, also keeps an eye out for mutual funds that are expected to complement certain ETFs. "We use active funds [where] we think the manager has an advantage and costs are reasonable." It helps to use institutional-priced funds, which have lower expense ratios than their retail equivalents, he adds.

It's also critical to thoughtfully select areas where active management appears to have an edge, Tuttle continues. As an example, he likes high-yield muni strategies with active oversight. "T. Rowe Price and Vanguard have pretty good funds [in these areas]. It pays to be more selective with states that have high levels of debt." Ultimately, "risk management is what makes active management attractive."

Diversifying portfolios by adding active management to the mix is a key selling point for using mutual funds, according to David Haraway, a certified financial planner with Substantial Financial in Colorado Springs, Colo. Using a selective mix of managers is similar to what many endowments and pension funds do, he says.

By Haraway's reckoning, spreading risk across several active funds minimizes the odds of blowback if one or two managers get into trouble. He adds that it's important to own funds that are pursuing different strategies.

"If I use multiple managers, my clients will have a higher risk-adjusted return, meaning that the return will be higher for the amount of risk taken," he asserts. By contrast, holding one ETF that more or less captures the aggregate of what the various managers are holding is effectively a bet on one manager, albeit in the form of a passively managed index fund."

Kashif Ahmed, president of American Private Wealth in Bedford, Mass., tells Horsesmouth that "not everything is worth buying as an index." He points to fixed income as an example. "The bond market is far more complex than the stock market," which leads him to advise that it's a "disservice to clients" to mechanically choose indexing strategies for allocating assets to fixed income.

Ahmed adds that plain-vanilla ETFs are designed for investors who aren't interested in researching the alternatives and instead are primarily interested in buy-and-hold strategies.

As for so-called smart-beta ETFs, which are marketed as quasi-active ETFs, Ahmed counts himself as a skeptic. "It's a stupid term," he complains. "Multi-factor strategies have been around for decades. Meanwhile, beta is beta."

A simple test

Can you do better by using traditional active managers? Even if you generate higher returns with active funds, does looking beyond standard ETFs come at the cost of higher risk? Or is the opportunity to generate superior results in risk-adjusted terms more than an academic possibility?

As a preliminary test, let's kick the tires on the idea and compare a passively managed, broadly focused U.S. equity ETF against an alternative asset allocation using an S&P 500 index fund for half the weight with the remaining 50% evenly split across five active, open-end funds that recently ranked high, according to Morningstar (4- and 5-star funds).

Yes, we're data mining here: using the benefit of hindsight to run a backtest using top-performing active funds. But the exercise may still be instructive since it offers some perspective on the prospects for trying to enhance a plain-vanilla ETF with a mix of well-run active managers.

For the benchmark, we'll use the Vanguard Total Stock Market ETF (VTI), which targets the broad U.S. equity market. To complement this ETF we'll carve up the broad U.S. equity market into the pieces shown in the table below, represented by one ETF and five active funds. The foundation (50% allocation) is a large-cap ETF—SPDR S&P 500 (SPY) —plus five actively managed mutual funds.

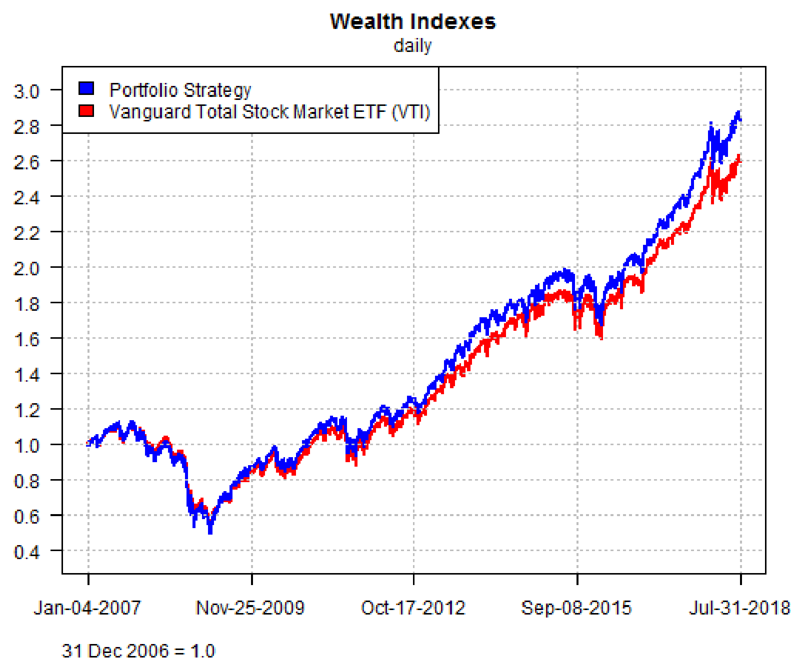
Figure 1: Our Alternative Asset Allocation
1 ETF, 5 actively managed mutual funds

Equity pool	Fund	Weight
large-cap stocks	SPDR S&P 500 (SPY)	50%
large-cap blend	Oakmark Investor (OAKMX)	10%
large-cap value	AIG Focused Dividend Strategy A (FDSAX)	10%
mid-cap growth	T. Rowe Price New Horizons (PRNHX)	10%
micro-cap value	Wasatch Micro Cap Value (WAMVX)	10%
micro-cap growth	Wasatch Micro Cap (WMICX)	10%

Source: James Picerno, Phd

The start date for the back test is the last day of 2006. The portfolio strategy is rebalanced back to the target weights at the end of each calendar year. Here's how a $1 investment in the benchmark (VTI) fared versus the portfolio strategy through the end of July 2018. VTI increased to $2.60 over that span while the portfolio strategy grew a bit more, to $2.84.

Figure 2: Wealth Indexes (daily)



Source: James Picerno, Phd

The table below shows how a select group of return and risk metrics compare. The main takeaway: the portfolio strategy's return is modestly higher over VTI's results—9.5% a year versus 8.6%—while the risk profile is similar, albeit with a slight risk-adjusted edge for the portfolio strategy. The strategy's Sharpe ratio (a risk-adjusted measure of performance) is a bit higher, for instance: 0.49 versus 0.43 for VTI.

Figure 3: Risk and Return Metrics

Risk & Return Metrics		
	VTI	Portfolio Strategy
Annualized return	8.6%	9.5%
Annualized risk (volatility)	**19.8%**	**19.3%**
Sharpe ratio	0.43	0.49
Sortino ratio	**0.72**	**0.79**
Maximum drawdown	-55.5%	-56.6%

Source: James Picerno, Phd

The key takeaway from this test is that while enhancing a conventional indexing strategy is possible, it's not easy, which is why indexing and simple rebalancing has become so popular.

Keep in mind that in the example above we had the advantage of picking active funds that had already generated strong results—an advantage that's not possible for real-time portfolio design. Even the most brilliant investment analyst is bound to pick a few duds.

To be fair, we can fiddle with the weights and/or the fund picks to engineer stronger results for the portfolio strategy. The danger, of course, is that we may be fooling ourselves by flirting with data mining.

Ultimately, it's a question of confidence—do you think you have what it takes to pick strong active managers who'll deliver higher return and/or lower risk versus a relevant benchmark in the years ahead? Numerous studies over the years strongly suggest that most advisors should stick with simple indexing and periodic rebalancing for managing client portfolios.

Granted, ETFs come with a unique set of pros and cons and so it's possible that the limitations in these funds can be sidestepped to a degree with a clever selection of active managers. But if you're primarily worried about ETF-related trading risks you can easily switch to their open-end index-fund equivalents.

The bigger question: Should you try to enhance the virtually cost-free beta that's available in passive portfolios? For most folks, history suggests the answer should be "No." But that's a rule for the masses and not every advisor thinks she's just another face in the crowd.

James Picerno is a freelance financial journalist and author of *Dynamic Asset Allocation: Modern Portfolio Theory Updated for the Smart Investor* (Bloomberg Press, 2010).

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